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*CONGRESSIONAL TESTIMONY*

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# Time to Evolve Beyond Traditional Employer-Sponsored Health Insurance for Small Firms

*Testimony of*

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My name is Stuart Butler. I am the Vice President of Domestic and Economic Policy Studies for The Heritage Foundation. Thank you for inviting me to testify today. The views I express in this testimony are my own, and should not be construed to represent any official position of The Heritage Foundation.

**Summary Points**

- *The nature of the workforce is changing,* as it is decreasingly characterized by traditional, long-standing employer-employee relationships.

- *Insurance is not sufficiently portable,* which endangers coverage when workers switch jobs or work arrangements and inhibits labor market efficiency.

- *Firms, and especially small firms, face difficulties and disincentives,* and they may not have either the capacity or the incentive to offer health insurance benefits.

- *Unequal tax treatment skews the system,* benefiting the employer-sponsored system to the exclusion of others and offering little relief to low-income families.

Crafting a better health insurance opportunities for working Americans in small firms includes three key elements.

1. *Create insurance exchanges.* State-chartered insurance exchanges would offer menus of portable health plans to working families and enable the development of large and diverse insurance pools with stable and predictable premiums.
    - A range of plans would be offered, much like the FEHBP.
    - With the state, exchanges would develop risk adjustment and pooling mechanisms.
    - Plans could be offered by organizations with a common affiliation, such as labor unions, farm bureaus or church consortia, with limited membership or open to all, much like the FEHBP.

2. *Transform employers into facilitators, not sponsors, of coverage.* Employers choosing not to sponsor coverage would take on the role of facilitating coverage by performing payroll deductions and consolidating and distributing premium payments.
    - Employers, either individually or as a group, would not be the risk holder or the direct purchaser of insurance. As in the FEHBP, employees would make the plan selection.

3. *Reform tax treatment.* Insurance exchanges would be explicitly given the same tax exemptions enjoyed by the employer-based system today. In addition, a cap on the tax exemption for health benefits and a refundable, advanceable credit for low-income families would be introduced to promote fairness.

## The Problem We Face[1]

The current employer-sponsored health insurance system has created two very different worlds. In one, long-serving employees of large firms receive adequate and dependable health-care coverage. In the other—which generally includes workers who are more mobile, part-time, self-employed, or employed by smaller firms—health-care coverage is far less predictable and often more costly. This challenge is only getting more urgent as increased labor mobility and escalating health costs strain the fraying employer-linked health infrastructure, leaving more workers facing dire health-care burdens or joining the ranks of the uninsured.

Our unique employer-based health system emerged out of historical accident. Most notably, the wage controls imposed during World War II and regulations providing the tax exemption for employer-sponsored health insurance encouraged employers to use health insurance coverage as compensation.

In some cases, this system operates well. But increasingly and especially for those in the small business sector, the traditional vision of employer-based system is insufficient to meet the needs of today's fluid economy and workforce. For the small business sector four significant factors contribute to the shortcomings of the present system.

- **The changing nature of the workforce**. The traditional case for employer-sponsored insurance implicitly assumes that families have a strong and continuous link with their workplace. But this is becoming less true in the United States. While in 1983, almost two-thirds of men in their fifties had spent 10 or more years with the same employer, by 2004, that ratio had fallen to about one-half. Today, as much as a quarter of the workforce changes jobs every year. In addition, the number of workers with alternative working arrangements, such as independent contracting, has increased substantially and now represents about 11 percent of the workforce, with another 17 percent of the workforce classified as part-time. These workers lack the close and long-standing links to large firms assumed by the current health coverage system.

- **Lack of insurance portability.** Though workers are more mobile, their health insurance is not. Changing jobs may mean giving up preferred doctors, losing specific drug coverage, or even losing coverage altogether. Health benefits have also become an influential factor in employment decisions. Workers are reluctant to leave jobs with good health-care coverage or to take jobs with insufficient health benefits, jamming labor markets and inhibiting labor market efficiency.

- **Difficulties and disincentives faced by firms.** Some firms, particularly small ones, struggle to offer health-care benefits to their employees. In fact, most very small firms offer no coverage at all. A large proportion of workers in certain types of firms

[1] Parts of this testimony draw from Stuart M. Butler's discussion paper: *Evolving Beyond Traditional Employer-Sponsored Health Insurance*. (The Brookings Institution, Washington D.C., 2007). Available at http://www.brookings.edu/papers/2007/~/media/Files/rc/papers/2007/05healthcare_butler/200705butler.pdf

are not even offered insurance. According to EBRI, data from the Census Bureau's Survey of Income and Program Participation for 2002 indicate that 54.1 percent of uninsured employees were not offered insurance by their employer. Firm size is the dominant factor. The annual survey of employers conducted by the Kaiser Family Foundation and the Health Research and Education Trust found that, in 2005, only 48 percent of firms with 3 to 9 employees, and 73 percent of firms with 10 to 24 employees, offered coverage at all, compared with 98 percent of firms employing 200 or more. Another Kaiser study found that almost half the decline in adults with employer-sponsored insurance during 2001-05 was due to employers (typically small firms) dropping coverage.

A small employee base limits the extent to which risks can be dispersed, making it more perilous for smaller firms to sponsor health insurance. In addition, small firms may have trouble shouldering the administrative burdens of health insurance sponsorship. Accordingly, firm size is a dominant factor in explaining whether a firm offers coverage: under half of firms with three to nine employees offered coverage in 2005, compared with 98 percent of firms employing 200 or more. Additionally, firms with relatively high turnover have little incentive to invest in the long-term health of their employees. Finally, the primary concern of firms is their bottom line; putting health benefits on a precarious footing should the firm need to cut spending.

- **Unequal tax treatment.** Employers receive a tax deduction for contributing to insurance coverage for their employees, as they do for most forms of employee compensation. But health insurance premium contributions are also excludable from the employee's taxable income, a tax break that totaled an estimated $210 billion in 2006. This tax break can be both unfair and inefficient. First, it is only available if the employer offers insurance, excluding millions of working families. Second, because the subsidy is effectively a tax deduction, the benefit is highly skewed towards upper-income employees with higher tax brackets and typically more generous coverage. Thus, whereas families with incomes of $100,000 or more received an average subsidy of $2,780 in 2004, families in the $40,000 to $50,000 range received only $1,448, and families making less than $10,000 received a meager $102.

## Avoiding the Mistake of Turning Small Firms into Large Insurers

As noted, owners of small firms face a lopsided playing field in trying to offer their employees health insurance. So it is understandable that an attractive approach to dealing with this might seem to be to find netter ways of enabling small firms to organize and finance insurance much like that offered by larger firms. That approach has led some analysts and lawmakers to proceed down the road of grouping small firms together in some way in order to increase their purchasing power and risk pool. The approach has also led to suggestions that tax breaks or other subsidies be designed to induce small employers to offer coverage.

While there might be elements of this approach which would somewhat improve the current situation, as a strategic step it is the wrong one.

For one thing it does not tackle the inherent weakness of using the place of employment as the determinant of coverage, a weakness that is especially problematic for small firms. Portability would still be a problem for employees in a sector marked by high employee turnover. It would be reduced somewhat if firms were grouped together, but there would still be a high probability of households encountering different plans or gaps in coverage when an employee changed jobs. And owners of firms would still lack the technical skills to provide good coverage – or they would have to contribute to the cost of such expertise in a cooperative or group of some form.

Moreover, trying to incetivize small firms to take on insurance responsibilities through such things as a special tax credit is likely to be complex and very expensive. In particular, a tax credit to subsidize small employer coverage could turn out to be among the most expensive ways of increasing coverage. If a credit were to be offered only for firms not now covering their employees there would be a perverse incentive for firms to drop their current coverage until they could quality for a credit as a non-offering firm. But if the credit were offered to all firms below a certain size, then money would be "wasted" on owners already covering their workforce. Meanwhile many small business owners would still not want to take on the responsibility of providing coverage even if they were offered a subsidy.

For these reasons the cost per newly insured individual associated with tax credits to employers is likely to be very high. Indeed, some reliable estimates put the cost at more than double the cost of other approaches, such as a credit directly to workers or an expansion of public programs.

## A Better Approach: Health Exchanges with Small Employers as Insurance Facilitators not Sponsors

An alternative approach is to start by envisioning a separation of the two functions of the employer in traditional employer-sponsored insurance: organizing or sponsoring insurance; and facilitating the transactions and other paperwork associated with coverage. We have been steadily separating these functions with employer-based retirement plans – by transferring the sponsorship function increasingly to mutual funds available through 401(k)s, while employers focus more on payroll deduction systems, financial contributions, and providing information. The same approach should characterize how we think of the future of health insurance coverage in the small business sector, with health insurance exchanges taking over the organization and sponsorship of insurance. While this shares some of the features associated with a small business cooperative, it differs in that it does not see the employer as part of an insurance cooperative. On the other hand, cooperatives based on union membership or other non-employer specific affiliations, would be compatible with the health exchange approach.

This separation of employer sponsorship and facilitating functions would be good for employees, since it would increase their choice of tax-advantaged plans by providing access to plans available through trusted agents in the exchange, rather than only plans selected by the employer. Families with plans obtained through an insurance exchange would also gain the certainty and true portability of coverage that millions of working families lack today.

The separation would also be good for employers. While the typically larger firms that are comfortable with traditional plan sponsorship could continue to organize and manage employee coverage, other employers could avoid those headaches. Yet they would also have an important new way of providing health benefits via the workplace—benefits that would typically be more attractive than those available through the vast majority of firms today, with expanded choice and improved portability. By delegating the cumbersome sponsorship functions, these employers could then focus greater attention on their core business activities. In addition, with the exchange itself distributing the insurance risk associated with higher-risk families, employers opting for the exchanges would have few or no concerns about potential medical problems associated with new hires.

Separating the sponsorship and facilitation functions would actually make it more attractive for smaller firms to make coverage available to employees, and even to contribute to it. With the exchange available as a source of coverage, small firms could offer access to a range of coverage that is normally unthinkable for them to offer today. And free of the administrative complexity and selection risk, many such firms likely would decide to contribute to comprehensive benefits (for example, through a defined financial contribution), rather than struggle to offer less adequate benefits themselves as they often do today.

This general approach has three elements:

**Element 1: A State-Based Health Exchange Approach**

The structural weaknesses of the employer-sponsored insurance system are likely to get worse over time, given the increasing mobility of the workforce and rising pressures from growing health-care costs. A health exchange addresses these weaknesses by giving all workers access to portable health insurance coverage, effective insurance pools, and the tax benefits provided to today's employer-sponsored system.

Insurance exchanges would be single-market clearinghouses offering menus of portable health plans to families via their employers. They would not operate insurance plans but would serve as the central venue for parties offering and purchasing health insurance. Examples of exchanges already in existence include Massachusetts' "Connector" and the Federal Employee Health Benefits Program (FEHBP). The latter provides complete plan portability within federal jobs, serving approximately eight million federal employees and retirees nationwide.

State Role. States would charter insurance exchanges under state law. States would take the lead in establishing the rules and regulations governing insurance and the functioning of the exchanges, as well as requirements, if any, regarding employer participation (though employers offering health insurance coverage under ERISA could continue their sponsoring role). This state-based approach has three important benefits: First, states would be better able to design exchanges to meet local conditions and needs. Second, variations from state to state would provide useful data about which models work. Third, it sidesteps logistically and politically difficult issues regarding federal versus state control, especially as insurance regulation is primarily a state function.

Alternative Pooling Groups. Under the exchange system, many organizations would be able to offer insurance under the same tax exemptions that employer-sponsored insurance receives today. Unions and religious organizations, for example, could take on this role. These groups could also offer coverage to workers outside of their regular membership, expanding the choices available to workers. Typically, they would negotiate with carriers to provide insurance rather than undertake the insurance risk themselves. These alternative insurance pools would free insurance from current ties to the workplace. Self-employed workers would be able to join insurance pools simply by virtue of being state residents, and all working families would have the opportunity to participate in insurance pools that were large, stable, and spread risk more effectively than many employers can.

**Element 2: The Employer as Facilitator, Not Sponsor**

Insurance exchanges would coordinate coverage options and facilitate the development of insurance pools, both things that the current employer landscape fails to do consistently. In addition, it would mean a change in the role of employers choosing not to sponsor health insurance, turning them into access points for the exchange. Though in theory people could join the insurance exchanges directly, employers would serve as useful intermediaries. Employers already have payroll deduction and tax withholding infrastructures, and employers have generally become efficient facilitators of payments over their long history of experience. Employers' proximity to workers could also boost enrollment, as workers could easily signup for benefits at their workplace. In addition, retaining an employer-centric system would enhance this approach's compatibility with the current system; this could reduce potential opposition and prevent disruptions to well-functioning employer-sponsored structures already in place.

Employers using the exchange would have two key functions: handling tax subsidies and organizing the collection and payment of premiums. This facilitation role would be nothing new for most firms. Employers of all sizes today are required to distribute IRS withholding forms, deduct amounts from paychecks for taxes, and remit money to the government. Employers also commonly facilitate employee payments into retirement and college savings plans, many of which are portable. The new roles under the insurance exchange would thus represent a minimal burden on employers, a point supported by survey data: the Commonwealth Fund has found that some 73 percent of large firms and 88 percent of small firms expressed willingness to organize payroll deductions and to coordinate premium payments for government-administered health programs.

Under this system, employers would benefit from more choice and flexibility. Employers could offer health benefits to their workers through the insurance exchanges without taking on the full burden of sponsorship, and in doing so could offer a much wider variety of plans than would be conceivable for most small businesses today. Employers could also continue to contribute to insurance, as many currently do, and could do so with more flexibility, including offering prorated plans to part-time workers (who could fund the rest of the plan from other family earnings). An additional benefit would be the freeing up of labor markets, as employees would no longer need to consider health benefits in making career decisions, and employers would no longer have an incentive to avoid potential hires based on their health risks.

**Element 3: The Tax Treatment of Health Insurance**

While states do not need federal legislation to create insurance exchanges, a clarification of federal rules would be important in order to ensure that exchanges can function as valid and equal alternatives to employer-sponsored health care. Specifically, federal language should explicitly allow qualified state health insurance exchanges to receive the same tax exemption that applies to employer and employee contributions today. Though this is generally possible today, ambiguity remains in various areas, such as what legal role the employer must play.

Wider tax reform, however, would make tax subsidies for health coverage more fair and efficient. For instance, Congress could enact a gradually tightening cap on the value of the tax exclusion for employer-sponsored health insurance while simultaneously introducing a tax credit for low-income families. Sponsored benefits above the amount of the cap would be taxed as cash compensation for families above a certain income. To minimize economic disruptions and political opposition, the cap could be structured to affect only a relatively small proportion of Americans initially, but be indexed at a rate lower than the expected rise of health benefit costs, so that over time, the number of people affected would increase. This cap would limit the inefficient incentive for employers to provide compensation in the form of health benefits (rather than other benefits or wage increases) and could encourage employees and employers alike to press for more economical health services.

The tax credit would be available to families below 200 percent of the poverty level and would be designed to offset most of the cost of a base plan. As many scholars have noted, a credit is more efficient and vertically equitable than a deduction or exclusion. The federal government would bear primary responsibility for funding the tax credit (which could be funded, in part, by potential revenue from the cap).

**Insurance Exchanges in Practice**

In sum, the exchanges would help to aggregate consumers into insurance groups, whether by employer, union, or other organizing scheme. The groups would pool large numbers

of participants with diverse risk profiles and choose among the plans offered by insurers through the exchange to provide coverage options to their members. The insurance exchange would provide the venue and regulation for these transactions. The access point for most consumers would be their employer, who would also facilitate payroll deductions, tax withholding, and premium payments.

The benefits would be multifold. Insurance premiums would be more stable and predictable, as workers would be pooled into large and stable groups, dispersing the risks of unpredictable and extreme costs. Consumers would have the choice of a variety of plans that they could keep from job to job while still being able to arrange insurance conveniently through their workplace. Employers could continue to offer their own coverage but would have the option of instead facilitating their employees' health benefits through the exchange system, with the ability to still contribute to their employees' plans. Furthermore, the development of more permanent relationships between workers and insurers would give insurance providers the incentive to craft policies designed and priced for long-term coverage, including more attention to lifelong wellness and preventive care.

That concludes my testimony today. Thank you for this opportunity. I look forward to your questions.

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